

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 01-0028
Indiana Gross Retail and Use Tax
For the Years 1997, 1998, and 1999**

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ISSUES

I. Assessment of Use Tax on Taxpayer's Scrap Bay Crane Trolleys.

Authority: IC 6-2.5-3-2(a); IC 6-2.5-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(2); 45 IAC 2.2-5-8(f)(1).

Taxpayer argues that the assessment of use tax on its scrap bay crane trolleys was erroneous. Taxpayer claims that the crane trolleys are used in the direct production of tangible personal property and are entitled to the manufacturing exemption.

II. Assessment of Use Tax on Taxpayer's Air Handling Equipment.

Authority: IC 6-2.5-5-3(b); 45 IAC 2.2-5-9(j); Ind. Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983); Dept. of State Revenue v. Kimball Int'l, 520 N.E.2d 454 (Ind. Ct. App. 1988); Ind. Dept. Rev. v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer states that its air handlers are used in the direct production of tangible personal property and are, consequently, not subject to use tax.

III. Assessment of Use Tax on Taxpayer's Control Room "Pulpits".

Authority: 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(2).

Taxpayer argues that its "pulpits" – enclosed booths housing operator personnel and various computer control devices – are directly used in its steel production process and are exempt from use tax.

IV. Assessment of Use Tax on Taxpayer's Control and Monitoring Equipment.

Authority: 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-8(j).

Taxpayer states that certain items of control and monitoring equipment – employed to monitor various aspects of its plating and surface treatment operations – are an integral part of its steel production process and are not subject to use tax.

V. Assessment of Use Tax on Taxpayer's Roof Lift Spare Parts.

Authority: 45 IAC 2.2-5-8(h)(2).

Taxpayer argues that its roof lift spare parts are equipment intended for eventual use in conjunction with its electric arc furnaces and, because the furnaces are used in the direct production of tangible personal property, the roof lift spare parts are exempt from use tax.

STATEMENT OF FACTS

Taxpayer is a manufacturer specializing in the production of steel and steel products. Taxpayer has multiple divisions with locations throughout the United States including one Indiana location. Taxpayer's Indiana location specializes in the production of hot and cold rolled sheet steel. During the audit, it was determined that certain of the taxpayer's equipment was subject to the use tax. Accordingly, the audit proposed additional use tax assessments, the taxpayer protested those assessments, a hearing was held, and this Letter of Findings followed.

DISCUSSION

I. Assessment of Use Tax on Taxpayer's Scrap Bay Crane Trolleys.

Taxpayer owns two scrap bay crane trolleys. The crane trolleys support electromagnetic cranes which are utilized to transfer various metal components into charging buckets. The scrap bay crane trolleys are integral to, and permanently attached to the electromagnetic cranes. The metal components are located within nearby scrap cars each of which contains a different form of scrap. Before the scrap cars are brought to the scrap bay, the contents of the individual scrap cars are pre-weighed for inventory purposes.

The metal components consist of pig iron, bushels, bundles, home scrap, and iron carbide. Non-metallic components consist of lime, charge carbon, and flue dust. Because each of the metal components has specific characteristics, the metal components are combined according to a pre-determined "recipe" and are measured by weight or by percent volume to achieve that desired "recipe." As examples, the taxpayer provides the crane operator with "recipes" for low residual carbon scrap steel, high residual scrap steel, and low nitrogen scrap steel. Taxpayer's "recipe for low residual carbon scrap steel, required the crane trolley operator to combine specific, measured amounts of bushling, home, bundles, pig iron, blend, lime, and carbon into the charging bucket. The components must be loaded into the charging buckets in a specified order. The loading order is specified in the "recipe" provided to the crane order. For example, the "recipe" for low residual carbon steel specifies that the lime and carbon are – respectively – the seventh and eighth elements introduced into the charging bucket.

The ratio of the various components is determined by their weight. The scale, used to measure the weight of the combined components contained within the charging bucket, is attached to a movable platform upon which the charging bucket rests.

The crane operator determines each metal component's weight by means of a cumulative read-out scale which is visible to the operator. After the crane trolley operator has produced the required mix of metal and non-metallic components, the charging buckets are used to deliver the mix to one of taxpayer's two electric arc furnaces. The electric arc furnaces operate to melt the metal and non-metallic components thereby producing the specified raw steel.

The audit determined that the scrap bay crane trolleys were pre-production equipment and were subject to use tax. Taxpayer argues that the scrap bay crane trolleys are integral to the first step in its production process and, therefore, are exempt from use tax.

Indiana imposes a use tax "on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC 6-2.5-3-2(a). However, IC 6-2.5-5-3(b) exempts certain production equipment from the tax "if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other personal property."

In order to qualify for the manufacturing exemption, taxpayer's equipment must be "directly used in the production process . . . [having] an immediate effect on the article being produced." 45 IAC 2.2-5-8(c). The equipment has such an "immediate effect" if it is "an essential and integral part of an integrated produces which produces tangible personal property." *Id.*

The same regulation provides an example that is analogous to the issue raised by taxpayer. 45 IAC 2.2-5-8(c)(2) states that "[t]he following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt . . . [a]n automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry."

Taxpayer's scrap bay crane trolleys are entitled to the use tax exemption provided under IC 6-2.5-5-3(b) because the cranes operate *within* taxpayer's integrated steel manufacturing process. The scrap bay crane trolleys do not simply provide ancillary transportation services prior to the steel production process. (See 45 IAC 2.2-5-8(f)(1)). Instead, the two scrap bay crane trolleys, the electromagnetic cranes, and the platform upon which the charging buckets rest, are constituent, functionally interconnected elements of an integrated process by which the production of taxpayer's finished steel begins.

The scrap bay crane trolleys are employed to combine the constituent materials by means of a precisely predetermined formula. The combining of the constituent materials – by

means of the trolleys, electromagnetic cranes, and movable platform – marks the beginning of an ongoing process of transforming those constituent materials into taxpayer’s finished steel products. Accordingly, the equipment directly involved in combining the constituent materials qualifies for the use tax manufacturing exemption.

FINDING

Taxpayer’s protest is sustained.

II. Assessment of Use Tax on Taxpayer’s Air Handling Equipment.

The auditor assessed use tax on the air handlers used to control temperatures within taxpayer’s cold mill motor control room. The motor control room contains electric drive motors which directly operate the reversing mill and temper mill. Also in the motor control room are computers which control the electric drive motors.

The audit determined that the air handlers were devices employed for general temperature control and, under 45 IAC 2.2-5-9(j), were subject to the use tax.

Taxpayer argues that the air handlers are essential and integral to its integrated steel production process. According to the taxpayer, the electric drive motors produce extremely high heat which would cause the computers to fail if the air handlers did not function to dissipate the heat. Taxpayer has provided specific information relating to the function of the air handlers. According to taxpayer’s electrical maintenance supervisor, the cold mill motor control room contains temperature sensors which set off an alarm if the temperature within the room reaches 80 degrees Fahrenheit. If the temperature within the motor control room continues to rise, the same sensors will automatically shut down the steel production process when the temperature reaches 90 degrees Fahrenheit.

In a factually analogous case, the court of appeals, in Ind. Dept. Rev. v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974), found that the manufacturer’s air handling equipment was not entitled to the exemption because the equipment did not have a direct effect on the manufacturer’s products. Id. at 100. Although the equipment was an “integral and essential” part of the manufacturing process, the equipment did not have the requisite “direct” effect on the manufacturer’s products. Id. at 98, 100. However in a later attempt to synthesize the cases interpreting the manufacturing exemption, the supreme court in Ind. Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983), held that, in order to fulfill the “directly used in the direct production” requirement, the equipment must have an “immediate link with the product being produced.” Id. at 525. The court found the RCA holding consistent with its own analysis because the RCA manufacturer – even without its air handling equipment – could continue to manufacture its own product, albeit less economically. Id. at 526.

Taxpayer has met its burden of demonstrating that the air handling equipment is entitled to the use tax exemption provided under IC 6-2.5-5-3(b). Taxpayer has demonstrated that the air handling equipment is used within the direct production of taxpayer’s steel

products, is an integral part of that production, and is not simply the “general temperature control” equipment described in 45 IAC 2.2-5-9(j). Unlike the RCA manufacturer, the taxpayer’s own air handling equipment is not simply employed to enhance and make more economical the taxpayer’s productivity. Rather the taxpayer’s air handling equipment is essential to the continuation of the taxpayer’s integrated manufacturing process and has the requisite “immediate link” with the taxpayer’s steel production. Cave Stone at 525. *See also Dept. of State Revenue v. Kimball Int’l*, 520 N.E.2d 454 (Ind. Ct. App. 1988). Taxpayer has demonstrated this integral relationship between the air handlers and its steel production by virtue of the fact that the entire system is designed to automatically cease production – upon reaching a predetermined cutoff temperature – thereby circumventing even the possibility of a more disruptive computer failure.

FINDING

Taxpayer’s protest is sustained.

III. Assessment of Use Tax on Taxpayer’s Control Room “Pulpits”.

The audit determined that taxpayer’s “pulpits” were subject to use tax. These “pulpits” are small, protected rooms located in proximity to the taxpayer’s steel furnaces. The pulpits contain computer controls, house furnace operator personnel, and are supplied with cooled air. Taxpayer argues that the pulpits are necessary to protect the computer equipment and operator personnel from the heat and sparks given off by the steel furnaces.

Taxpayer has provided photographs documenting the manner in which the pulpits are employed in its steel production process. From the photographs, it appears that the pulpits are located approximately 30 feet from taxpayer’s steel furnaces. In one of the photographs, sparks given off by one of the furnaces land immediately in front of the pulpit. In another photograph, a worker standing outside the pulpit is wearing substantial protective clothing. Taxpayer states that the steel furnaces produce temperatures of 2,900 degrees Fahrenheit.

Enclosed within the pulpits is the computer equipment used to control the furnace operation. However, the computer equipment does not autonomously control the furnace operation; the computer equipment requires the active participation of the human operator. For example, at a certain stage in the furnace operation, the operator touches an icon on the computer screen to open or close the furnace roof. At another stage, the operator touches another icon to cause the electric power to begin charging the contents of the furnace or to cease charging the contents. At yet another stage, the operator touches a computer icon to “tap” the furnace and discharge the furnace contents into a ladle.

Setting aside the issue of whether taxpayer’s pulpits protect the enclosed computer equipment or whether that same equipment is itself involved in taxpayer’s steel

production, the pulpits are entitled to the use tax exemption as specified in 45 IAC 2.2-5-8(c)(2). The regulation states that “[t]he following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt . . . [s]afety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.”

The pulpits are entitled to the use tax exemption set out in 45 IAC 2.2-5-8(c). Based upon taxpayer’s description, it is apparent that the pulpits are necessary to permit otherwise unprotected personnel to operate the steel furnaces. Clearly, the pulpits are not provided for the comfort or convenience of taxpayer’s operating personnel but are equipment essential in permitting the workers to participate in taxpayer’s steel production process.

FINDING

Taxpayer’s protest is sustained.

IV. Assessment of Use Tax on Taxpayer’s Control and Monitoring Equipment.

The audit determined that certain items of control and monitoring equipment were subject to use tax. Those items included: (1) flight recorders; (2) thermal scanners; (3) FCE atmosphere monitors; and (4) hot mill PDA system. The audit found that the equipment did not have “an immediate effect upon the article being produced . . .” 45 IAC 2.2-5-8(g). Instead, the equipment was part of taxpayer’s “non-operational activities” and was subject to use tax under the provisions of 45 IAC 2.2-5-8(j).

The taxpayer argues that the equipment monitors its production process providing data to the mill operators which, in turn, allows the operators to interact with the production machinery and equipment. Accordingly, taxpayer asserts that the equipment is entitled to the exemption afforded under 45 IAC 2.2-5-8(c).

Taxpayer’s thermal scanners are used to monitor the temperature of slab steel during the production process. If the temperature of the steel slab falls below 1,975 degrees Fahrenheit, the thermal scanner detects the temperature change and the amount of water being sprayed on the slab steel is reduced. Reducing the amount of water allows the temperature of the steel to remain at the specified level. Taxpayer has provided evidence demonstrating that maintaining the specified temperature is critical to producing steel of the desired quality. Accordingly, because of the immediate, functional interrelationship between the thermal scanners, the water sprayers, and the production of the slab steel, the thermal scanners are entitled to the use tax exemption. Under 45 IAC 2.2-5-8(c), the thermal scanners have an “immediate effect on the article being produced” and are an “essential and integral part of [taxpayer’s] integrated process.”

The remaining three categories of equipment – the flight recorders, FCE atmosphere monitors, and hot mill PDA system – are not entitled to the use tax exemption because

they are not integrally related to the taxpayer's steel production process. For example, the audit found that the flight recorder "measures and monitors the performance of the mill . . . [and] communicates this information to [the] level 3-administration and business system." Taxpayer maintains that these three categories of equipment are essential to producing quality steel. Undoubtedly, the three categories of equipment play an important part in the production of taxpayer's steel. However, as noted in 45 IAC 2.2-5-8(g), "The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not itself mean that the property 'has an immediate effect upon the article being produced.'"

FINDING

Taxpayer's protest is sustained in part and respectfully denied in part.

V. Assessment of Use Tax on Taxpayer's Roof Lift Spare Parts.

Use tax was assessed against one of the taxpayer's invoices for "roof lift spare parts." Taxpayer argues that the roof lift is used within the steel production process and therefore, under 45 IAC 2.2-5-8(h)(2), the roof lift spare parts qualify for the use tax exemption. 45 IAC 2.2-5-8(h)(2) reads as follows:

Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

The "roof" referred to by taxpayer, is the lid of one of taxpayer's electric arc furnaces. From the photograph provided by the taxpayer, the roof appears to be approximately 25 feet in diameter. The lift is physically attached to the roof and used to elevate the roof, rotate the roof away from the furnace, and allow the scrap bucket to empty its contents into the furnace. Taxpayer has a roof lift for each of its two electric arc furnaces.

The roof lift is integral to the electric arc furnaces. The electric arc furnaces are clearly central to the taxpayer's steel production process. Accordingly, the roof lift spare parts are entitled to the use tax exemption provided under 45 IAC 2.2-5-8(h)(2).

FINDING

Taxpayer's protest is sustained.